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Presumptive taxation – design and policy considerations

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Azerbaijan Competitiveness and Trade (ACT) Project

Presumptive taxation – design and policy considerations

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1. BACKGROUND AND INTRODUCTION

The Ministry of Finance of Azerbaijan has requested some assistance in the area of simplified tax or rather taxation of Micro and Small Enterprises (MSEs) and Small and Medium Sized Enterprises (SMEs)

This paper is largely based on the publications “Designing a Tax System for Micro and Small Businesses: Guide for Practitioners” published by the International Finance Corporation, World Bank group, in 2007 to which reference should be made for more elaborate descriptions and “Taxation of SMEs: Key Issues and Policy Considerations” which is No. 18 in OECD’s Tax Policy Studies and contains descriptions of studies and experiences gathered in the member countries.

2. MAIN CATEGORIES OF PRESUMPTIVE TAXES

Presumptive tax systems basically can be grouped in four categories:

- (i) Systems based on turnover or gross income.
- (ii) Systems based on indicators.
- (iii) Simple lump-sum patents.
- (iv) Systems based on agreement between taxpayer and tax administration.

Type of system	**Tax base Indicator**	**Advantages**	**Disadvantages**	**Examples of countries**
Patent	Type of activity	a) Easy to administer b) Positive incentive effects c) Minimize tax administration discretion	a) Poor revenue performance b) Ignores taxpayer specifics c) No vertical equity d) Regressive	Bulgaria, Kosovo
Indicator-based system	Group of indicators as proxy for business income	a) Positive incentive effects b) Tax burden differentiated	a) Distorts investment decisions b) Selection of appropriate indicators is difficult c) No tax reduction for lossmaking MSEs d) System design requires substantial external data	Spain, Italy, Argentina

Type of system	Tax base Indicator	Advantages	Disadvantages	Examples of countries
Turnover-based system	Business turnover	a) Minimum level of equity b) Easier transition from presumptive to standard regime c) High revenue potential compared	a) High risk under-declaration b) High risk of corruption c) Favors businesses with high profit margins	Russia, Kazakhstan, Azerbaijan
Agreed systems	Indicators plus agreement between taxpayer and tax administration	a) System reflects taxpayer specifics	a) Extremely high corruption and collusion risk b) System requires extensive data collection and analysis	Previously France

A number of countries have introduced withholding taxes on for instance payments to consultants and sub-contractors and on imports by MSEs to reduce tax evasion from such MSEs. If the withheld amount exceeds the actual tax the MSE can claim a refund while for non-registered MSEs the withheld amount becomes the final tax. In addition to reducing evasion, withholding taxes is an incentive to register for tax. The disadvantage is that it imposes considerable compliance costs on the payer and it can therefore only be imposed on large manufacturers, wholesalers, government bodies and similar public entities.

2.1. Presumptive taxation based on turnover or gross income

Presumptive taxation based on turnover or gross income can be the only way of taxing the small businesses' segment or it can be a minimum taxation. This is the most used type of presumptive taxation as it offers several advantages such as, opposed to patents and pure indicator-based regimes, applying a tax proportional to the volume of the business although the tax burden is not connected to the profit made. This is also if comparing to indicator-based presumptive taxation an advantage for newly established businesses that are not fully operating. Further also small businesses will need to do some basic bookkeeping which would prepare them for the transition to the ordinary tax system in case they grow out of the presumptive tax.

Further, turnover may be seen as a more accurate estimate of the profit than size of business premises, energy consumption or staffing. In addition it avoids the problem of the tax becoming a tax on staff which it would be if the tax burden depended on the number of employees. Finally it is simple to calculate the tax.

There are different ways of calculating a turnover-based presumptive tax. The most basic is to apply a **uniform percentage** to all types of small businesses' turnover. This does not take into account that different types of business have different cost structures and therefore also different profit margins. It is therefore necessary to apply a low tax rate or a high standard deduction in order to avoid over-taxing certain types of businesses. The Azerbaijani simplified tax is an example of a basic turnover-based presumptive tax. It applies to legal entities and natural persons annually turning over less than AZN 150,000 and AZN 90,000, respectively. The tax rates applied to the turnover are 4% for taxpayers in the capital region and 2% in the remaining part of the country. Another example can be found in Ukraine where legal entities with less than 50 employees and turning over less than 1 million UAH (app. 200,000 USD) can pay a 6% tax rate on turnover if it replaces corporate income tax only and 10% if also VAT is replaced.

It is also possible to have a **progressive turnover-based presumptive tax**. Under such regime businesses with different levels of turnover can be taxed differently. Kazakhstan operates such a system.

The main advantage of the progressive turnover-based presumptive tax is that the difference between the taxation in the top bracket of the presumptive tax will be closer to the level of taxation in the standard regime thus easing the transition but it comes at the cost of increased complexity of the presumptive tax regime.

Different types of businesses have different levels of profit margins – some businesses are labor intensive; others are not; others have large costs to suppliers; and finally some have no or very low costs (such as small providers of consultancy services). In order to address this either **different tax rates or standard deductions** may be applied to different segments reflecting the average profit-to-turnover ratio in those segments. Obviously it is very easy to get in a position where each business code wants its own regime which would make the “simplified tax” very complex and difficult to maintain as the profit-to-turnover ratios must be reviewed on a regular basis.

Such an approach can differentiate between traders of goods and businesses providing services. It is a fairer system but it also imposes complications to taxpayers selling both goods and services.

Brazil and France operate such presumptive taxes. The Brazilian presumptive income defines the tax base as 8% of the turnover with tax rates of 1.6% for trading businesses, 16% for transport businesses and 32% for service businesses. The French presumptive tax is for small trading and catering businesses turning over less than app. €80,000 and service businesses less than app. €30,000. The tax base is 29% of turnover and the standard tax rates apply.

It is important to keep it simple such as for instance operating only with a distinction between “traders” and “service providers”. There is an example of a country[1] that is attempting to administer a fair regime operating with 69 different professions and 19 turnover bands with progressive rates for each profession which means there are 1,311 tax rates.

[1] Ethiopia.

The main challenge when designing a presumptive tax is the setting of the rate/defining the standard deduction reflecting the average costs of doing business. There is no easy way of doing this – only extensive analysis of business sectors and their costs structures and profit ratios can give indications of the answers. The challenge faced can be illustrated by the experience of Hungary that introduced a 15% tax on turnover replacing corporation tax, dividend tax, company car tax and value added tax. The scheme was very popular in high-profit areas such as accountants, lawyers, IT firms and small consultancy businesses.

There is no general guideline for the determination of the tax rate in case of a turnover-based presumptive system. Extensive analysis of average MSE profit margins is required before setting the rate.

It is possible to build in incentives to improve keeping records by operating with a higher tax burden for taxpayers keeping rudimentary records and lower tax burden for businesses that keep complete records.

A serious weakness of turnover-based presumptive tax is the risk of under-declaration of turnover which is particularly difficult to detect by the tax authorities in a cash-based economy. Mandatory use of **electronic cash registers** is one element in promoting some taxpayer compliance. In some countries such as Serbia and Bosnia and Herzegovina it is a requirement that cash registers are online connected to the tax authorities to whom information on turnover is transferred directly.

Cash registers further require checking in order to ensure that they have not been altered or tampered with which require many tax control resources that may be better utilized for other tasks. In general mandatory electronic cash registers are not the recommended approach to reducing the risk of evasion of SMEs. However experiences show that traders and customers often operate with two prices – one with and another without receipt – so regardless of the requirements to cash registers there is no certainty that turnover is actually registered in the cash register.

Obliging small business operators to keep electronic cash registers is therefore in general not a recommended approach to reduce evasion risks. A more promising approach is the introduction of incentives for issuing receipts. This can be done, for example, in the form of organizing receipt lotteries. The Philippines operates a weekly price draw in which participation is done by sending a text message with the vendor's taxpayer registration number, the receipt number and the amount to the tax administration. The draw is performed in cooperation with the national lottery.

Another approach is to facilitate and promote the use of cashless payments (credit cards). The Korean government wished to increase the use of paying by credit cards and introduced a tax deduction for 20% of the costs of using the credit cards in 1999 and combined it with a lottery that distributed $17 million to credit card users in 2000. Payments with credit cards increased from around $35 billion to $165 billion.

Although very difficult and costly to monitor and enforce it can also reduce the risk of under-reporting the turnover of MSEs if there is an obligation to make bank transfer of payments exceeding a certain larger amounts.

Combining the turnover-based presumptive tax with taxation based on indicators can also bolster it against evasion through under-reporting. It could in order to address the risk of under-reporting be tempting to base a presumptive turnover-based tax on a presumed turnover (defined in law or regulations) instead of using the actual turnover reported by the taxpayer. That would be wrong as it would be a patent system and should be labeled as such.

2.2. Presumptive taxation based on indicators

The main alternative to the turnover-based system discussed above is a presumptive tax system based on indicators providing a proxy for the taxpayers' profit or taxable income in a standard tax system.

Indicators must be easy to verify and put on record; they must be difficult to falsify; and they must as said above give a good indication of the taxpayers' income.

Traditional indicators have been size of premises, staffing, inventory; capacity of machinery; years of operations and consumption of utilities.

Spain operates an indicator-based system for taxing restaurants. The indicators are number of paid employees, number of unpaid persons working in the business; energy consumption; and equipment of two different types. The disadvantage is that an indicator-based system becomes a tax on the indicator: the tax burden increases if another staff member is employed, so employment is discouraged – increased electricity consumption will also increase the tax burden thus making the owner reconsider prolonging opening hours and in this way expand the business. Again from the taxpayers' perspective the tax becomes a tax on the indicator and not on the profit of the business.

In addition to simplifying taxation of MSEs and SMEs, introducing indicator-based presumptive taxation for restaurants is also based on the experience that it is notoriously difficult to verify the information on their profit submitted to tax authorities by catering industry operators operating in a cash environment. The same applies to the transport sector and some countries have taken the consequence and introduced a periodically collected lump sum per type of vehicle in lieu of standard taxation of the profit.

Indicator-based systems appear to have some major advantages over turnover-based systems. It is more difficult to hide the existence of the indicators than to suppress turnover so indicator-based systems should be more robust against evasion. The existence of the indicators is at least for some of them objectively verifiable so there should be less discussion between taxpayer and tax authority over the presumptive tax liability. There is no need for any bookkeeping – not even the reduced registration of turnover in a turnover-based presumptive taxation system.

Experience shows, however, that indicator-based systems also have their challenges in terms of design and application. It is for instance not obvious that there is a direct correlation between the size of a business' premises and its profit. The same applies to location – a retail store on a big city's busy high street will everything else being equal yields a better profit than the same equipped store in a small town. Some indicator-based presumptive tax systems therefore seek to introduce indicators for location and quality of premises thus adding considerable complexity including some elements of discretion to the system.

The indicators themselves require considerable efforts in terms of data collection and analysis of cost structures and profit margins in order to ensure that they are reasonable proxies for the income – and they will regardless of all efforts cause ongoing and continuous disputes or at least discussions with the business community, as it will always be possible to find cases where the indicators have unintended consequences.

As the indicator-based presumptive tax will be seen as a tax on the indicator, businesses will be reluctant to expand as moving to bigger premises and employing more staff will increase the tax burden even though it occasionally at least temporarily can cost on the turnover side to relocate and expand. This element of tax on the indicator also means that there will be an incentive to keep staff off the records if the staffing level is an indicator.

Newly established businesses will almost always be loss making in the beginning. An indicator-based presumptive tax should therefore be designed to avoid taxing newly established businesses without opening a door for avoiding the tax by changing the identity of the taxpayer by selling the business to another entity controlled by the same people every time the relief for newly established businesses is due to expire.

Indicator-based systems will always be more complex than turnover-based systems because indicators would need to be defined for each business segment and that is a complicated process causing discussions and disputes with trade. Due to those difficulties indicator-based systems cannot be the preferred option for presumptive taxation in general but should, if applied, be limited to a small number of business segments.

2.3. Combination of turnover and indicator-based systems

Under-declaration of turnover can be reduced if elements of indicator bases presumptive tax are added to turnover-based system. Argentina has introduced certain counter evasion features consisting of defining the minimum tax base based on size of business premises and energy consumption. The system is not flawless as it punishes small businesses with sizeable premises in times of low business activities and it also does not take into account that energy consumption may be very different between different segments of businesses. It is therefore questionable to which extent the indicator based presumptive taxation is recommendable over turnover-based systems in countries with developed tax administration capacity, but it may very well be considered where tax administration is weak.

2.4. Patent systems

Patents are the simplest form of presumptive tax being that if the taxpayer owns a business it is presumed he or she makes a profit which it taxed by a lump sum regardless of the size of the actual profit.

The main advantages of a patent system are that there is no requirement to estimate the business profit. A patent system also promotes growth as businesses are not additionally taxed by for instance hiring more staff or moving to bigger premises and the tax burden is transparent and predictable not requiring any control and audit activities of the tax authority.

The disadvantages are that patents are seen as unfair: newly established businesses or businesses suffering downturns are subject to the same taxation as thriving businesses so a patent does not adhere to the principle that taxes should paid by those who have the ability to pay.

However unfair patent systems may occasionally be seen it is still a very efficient system for "taxing the hard-to-tax". In Kosovo moving traders, artisans and certain other low income groups are taxed by paying a quarterly patent of around €40.

Bulgaria introduced a more sophisticated patent system with differentiated business activities and locations: A hairdresser or barber pays more than a carpenter and a carpenter in a major city pays two times more than a carpenter in a smaller regional center and 10 times more than a carpenter in a village. The Bulgarian system operates with 43 business sectors and a number of zone locations requiring more than 300 specific tax amounts to be updated regularly. This was, however, not seen as being sufficiently fair so each business sector is divided into subcategories and each subcategory is further divided based on the characteristic for the individual business.

This means that 52 tax rates are set for "mass catering and amusement establishments". Obviously the system is not accepted by the taxpayers and both the categorization and tax rates are constantly challenged, meaning that simplification has not been achieved: Why should a poorly located hairdresser in a big town pay four times more tax than a hairdresser in a prime location in a smaller town? The latter may very well have the better business.

Patents should therefore only be used to tax hard-to-tax micro businesses and the primary objective is not the revenue generated as that would be almost negligible compared with the cost of collection but more to prepare taxpayers for being a part of the presumptive or standard systems when their businesses grow. Georgia has given full consideration to the revenue side and taken the decision to exempt micro businesses from any taxation if the annual turnover is less than GEL 30,000 (app. AZN 15,000).

2.5. Agreed systems

France had a presumptive taxation system that required an agreement between the tax administration and the taxpayer. It has now been replaced by a turnover-based system because it required extensive collection of data and estimates of profits. Based on the general data and statistics and information on purchases, sales, value of closing inventory, staffing, wages paid and numbers of cars owned the tax administration prepared an estimate that was discussed and agreed with the taxpayer. Keeping in mind the system was for MSEs and that the estimates were much higher than the agreed amounts, it is not surprising that the system has been abolished.

Agreed systems are not common in practice due to the costs of operating them; it is against the principle of self-assessment; and probably most importantly they have extremely high risks of corruption.

3. CERTAIN SPECIFIC ISSUES

3.1. Taxes to be replaced by presumptive taxes

In theory a presumptive tax could replace any indirect and direct tax but it should only after very careful consideration be replacing other taxes than the standard profit tax as other taxes whether being direct or indirect taxes occasionally serve other purposes that may not be pursued if the tax is replaced by a presumptive tax. It should also be noted that social contributions of business owners should not be replaced by a presumptive tax because payments of contributions create a right requiring a direct link between the size of the contribution and the size of the right.

Also taxes and contributions withheld on behalf of employees should not be replaced by a presumptive tax. The options are to keep a pay-as-you-earn withholding scheme or to swift the obligation to the employees if it is considered necessary to reduce tax compliance costs of MSEs. The latter is usually not recommendable from a tax administration point of view.

It could be argued that VAT should be considered included in or replaced by a presumptive tax. In general it is more appropriate to set a threshold for VAT registration that is sufficiently high to ensure that MSEs are not included under the VAT. However, the threshold should not be so high that SMEs are not included under the VAT, too.

In some cases there are local taxes and fees that could or should be included in the presumptive tax. That will require that the funding requirements of the previous beneficiaries of such taxes and fees are addressed.

3.2. Treatment of professionals

It is particularly difficult to design a presumptive tax for professionals. It could be sensibly argued that professionals should not be included in a presumptive tax – they generally have high income and are sufficiently educated to keep books and file tax returns. The counter argument would be that professionals are also a particular risky group when it comes to tax evasion. This favors inclusion of professionals under a presumptive tax if there is no strong tax administration in place that can monitor such groups' compliance with the requirements under a standard taxation regime.

Turnover is further not particularly suitable for taxing professionals as that would be subject to the same risk of tax evasion as standard net profit taxation would be (under-reporting). For some professions such as lawyers, accountants and pharmacists size of premises and staffing may be relevant while for instance for doctors it may be relevant to look at the number of years in practice.

3.3. Newly established businesses

Presumptive taxation usually taxes a business from the day it opens disregarding the costs of establishing the business. Trade representatives and others will often argue that tax holidays may be a suitable tool to protect such new businesses.

Such incentive schemes in OECD countries have been assessed and the conclusion was that tax holidays are largely inefficient and prone to abuse. It is usually very easy for MSEs to change their name and legal identity just before the expiry of the tax holidays thus being able to use tax holidays "forever". The only way of addressing that is to make the holiday period so short – e.g. 6 months – that is not worth the bother to change the identity of the taxpayer or to limit it to natural persons – entrepreneurs but then it may be questionable if the holidays at all make any difference. A slightly better solution than tax holidays could be a temporary tax reduction for a few months for newly-established MSEs.

The best solution with respect to not taxing newly established and other temporarily loss making businesses seems to be to allow them to carry forward losses. That requires obviously that the bookkeeping is of such standards that the tax administration can use it as a basis for its tax compliance work.

3.4. Transition from presumptive to standard tax schemes

A big difference between the level of taxation under the presumptive scheme and the standard regime will cause businesses to hesitate from growing out of the presumptive scheme or even to split into more entities in order to migrate from the standard to the presumptive regimes.

The best way of aligning the presumptive taxation with the standard tax regime seems to be to ensure that the presumptive taxation at the upper end of the scale is not substantially lower than taxation at the lower end of the standard regime and that the accounting and filing requirements are also gradually increased.

Such coordination could be ensured by a system composed of the following steps:

Business Size	Tax Base and Rate	Accounting and Filing Requirements
MSEs	Exemption (in case of subsistence level micro-business) or simple patent	Simple cash-book
SMEs below general tax system threshold	Presumptive slightly progressive tax based on turnover	Simple cash-book
SMEs with turnover slightly above presumptive system threshold	Application of standard tax system (including VAT)	Simplified record keeping and return filing

A presumptive tax system for small businesses needs to be well coordinated with the standard tax regime to facilitate migration to the standard regime; avoid both over- as well as under-taxation of small businesses; be transparent and fair; and be easy to administer and supported by taxpayer education and information programs that really reach the MSE community.

In short:

Kind of taxpayers subject to presumptive taxation:	- Presumptive tax regimes should be limited to small businesses operated by individuals (entrepreneurs) - Incorporated firms could be subject to the standard taxation regime - Professionals and free lancers should be required to keep (simplified) books and file an income tax return - All other MSEs should have access to presumptive taxation that may be designed to suit different segments

Threshold	- No ideal applicable to all countries
	- Threshold for presumptive tax should correspond to the VAT threshold unless that is very high as is the case in Azerbaijan. It should therefore in an Azerbaijani context be considered to introduce
	    o an exemption or patent for the smallest MSEs – turnover up to e.g. AZN 10,000 or 20,000
	    o a mainly turnover-based presumptive tax for the business segment up to the VAT registration threshold
	        ▪ current threshold is very high
	    o corporate taxpayers are dealt with in the standard system
	- Business turnover should be the main criteria for presumptive system

Determination of tax liability	- Turnover better reflects the profit than indicator based. - Turnover-based systems facilitates migration to standard system - Indicator-based systems, if used at all, should be limited to high risk groups such as the transport sector (in particular taxi drivers), restaurants and bars, hair dressers, barbers and beauty salons and gambling establishments
Tax rate	- The trading and the service sectors have substantially different profit margins so their presumptive tax burden should be different - Better to apply different standard deductions and then apply the standard tax rate to the amount of turnover less standard deduction than to apply different rates - Too complicated to further than between “traders” and “service providers”
Taxes to be replaced	- Any tax may be replaced except contributions of the entrepreneur and pay-as-you-earn taxes and contributions of employees o The tax and contributions authorities must do much more to ensure that employers and employees are not evading payments of such dues by rebranding employment relations as free-lance provision of services - Taxpayers should have the option to opt out of presumptive tax regime